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10:00 a.m., July 6, 1988

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Abdallah	
F. Cassell	
Dai Q.	
C. H. Dallara	D. C. Templeman, Temporary
J. de Groote	J. Prader
A. Donoso	E. V. Feldman
	M. B. Chatah, Temporary
G. Grosche	
J. E. Ismael	J. Reddy
A. Kafka	J. Hospedales
M. Massé	
	N. Toé, Temporary
Y. A. Nimatallah	I. A. Al-Assaf
	L. Filardo
	M. Fogelholm
	D. Marcel
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
G. Salehkhou	
	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
M. Primorac, Assistant

Also Present

African Department: A. D. Ouattara, Counsellor and Director. Asian Department: R. J. Hides. European Department: M. Guitián, Deputy Director. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; D. Burton, S. Kanesa-Thasan, C. Puckahtikom. External Relations Department: A. F. Mohammed, Director. Fiscal Affairs Department: K. Nashishibi. IMF Institute: O. B. Makalou. Legal Department: F. P. Gianviti, General Counsel. T. M. C. Asser, P. L. Francotte. Middle Eastern Department: C. A. Yandle. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; L. Alexander, D. A. DeRosa, E. Hernández-Catá, N M. Kaibni, B. E. Rourke. Treasurer's Department: D. Gupta, H. C. Kim, Y. Ozeki. Western Hemisphere Department: M. Caiola, Deputy Director. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: W. N. Engert, A. G. A. Faria, S. M. Hassan, P. Kapetanović, Khong K. N., K.-H. Kleine, P. Péterfalvy, G. Pineau, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: N. Adachi, R. Comotto, S. K. Fayyad, V. J. Fernández, S. Gurbye, M. Hepp, L. Hubloue, A. Iljas, C. Y. Legg, S. Rouzi, Shao Z., C. C. A. van den Berg.

1. COMPENSATORY AND CONTINGENCY FINANCING FACILITY - MODALITIES

The Executive Directors considered a staff paper on modalities for the compensatory and contingency financing facility (EBS/88/100, 5/24/88; and Cor. 1, 5/25/88), together with a draft decision relating to compensatory and contingency financing (EBS/88/128, 7/6/88). They also had before them a statement made by the staff at EBM/88/100 (6/27/88) on issues related to modalities for the compensatory and contingency financing facility.

The staff representative from the Exchange and Trade Relations Department made the following statement:

> This note sets out the staff's understanding of the basis on which Executive Directors might be prepared to agree on the various issues related to the compensatory and contingency financing facility. The staff was also asked to discuss how double compensation might be avoided if the minimum threshold was not deductible; to present some calculations illustrating the possible effect on the use of Fund resources of covering interest rate contingencies; and to examine how the aggregate contingent deviation should be calculated when interest rate contingencies are subject to a special sublimit. These three latter points are addressed in Appendices A, B, and C, respectively.
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> 1. Access limits for contingency mechanisms
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> Contingent financing would not generally exceed 70 percent of access under the associated arrangement. For multiyear arrangements there would be a flexible approach for distribution of access as between years; normally, some front-loading and carry-over of access would be provided for, but access in any one year would not generally exceed 70 percent of the access available under the associated arrangement in each 12-month period. Contingent financing also would be subject to the cumulative access limits for the facility (for example, up to 65 percent of quota for members opting to apply the optional tranche to contingent financing).
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> 2. Activation
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> Contingency mechanisms generally would be activated on the basis of a review by the Executive Board. Such reviews would normally be conducted within the context of a midterm program review, although in some cases it might be useful to conduct an ad hoc review. In some exceptional cases where the link between additional financing needs and the relevant contingencies and the policy actions that would need to be phased in could be specified in advance with sufficient precision, disbursement of contingent financing might proceed without Executive Board

review. In all cases, disbursement would of course require observance of the arrangement's performance criteria, adjusted by the Executive Board as necessary to take account of the effects of the contingencies.

3. Resources for contingent financing

Purchases for contingent financing will use ordinary resources with a repurchase period of three to five years. Access would be considered separate from holdings resulting from the use of Fund resources under any other policy but not from holdings resulting from purchases on account of export shortfalls or excess cereal costs. As is the case with purchases under tranche policies, purchases for contingent financing and holdings resulting from such purchases would be excluded for the purpose of determining a member's reserve tranche position.

4. Choice of the optional tranche

The optional tranche would be divisible. Prior to activation of a contingency mechanism, members would be free to choose the application of the optional tranche, except when the Fund at the request of the member specifies in advance an allocation of the optional tranche; this would involve mainly cases where parallel contingency financing was being arranged. At the time of activation of the contingency mechanism, members would commit themselves on the use of the optional tranche for the remaining period of the baseline.

5. Minimum threshold

For an experimental period until the general review of the facility, the staff would work with a de minimis threshold of 10 percent of quota, but management would have the freedom to propose a lower or higher figure in what is expected to be the relatively few cases where this was appropriate. The threshold would not be deducted before calculating the financing to be made available or before applying the symmetry procedures. The staff would evaluate the margin being incorporated in Fund arrangements and, to the extent that the threshold was covered by such margin in the basic program, Fund contingency financing would not be provided to finance the part of the deviation within the threshold (see Appendix A). The symmetry provisions of the contingency mechanism would not apply until the favorable deviation exceeded the size of the margin.

6. Proportion of deviation to be financed

The proportion of deviation to be financed would be determined on a case-by-case basis and established at the outset of the arrangement with a contingency mechanism: the proportion

could be changed by the Fund at the request of the member at the time of the activation of the contingency mechanism if the program was being affected by shocks that warranted such a change to assure viability of the program.

7. Phasing

Contingent financing would be phased on the basis of the timepath of the net deviation from the baseline and the timing of the implementation of additional policy measures. When a shock covered by the contingency variables had occurred, the first purchase would be made available when the cumulative deviation from the baseline was projected to exceed the threshold. Subsequent purchases would be proportional to the net deviation estimated for the corresponding quarters, on the basis of shocks that had already been observed. [There could be a general provision that when a member has made a purchase on the basis of estimated data and the amount of the purchase exceeds the amount that could have been purchased on the basis of actual data, the member would be expected to make a prompt repurchase in an amount equivalent to the overcompensation.] Actual use of contingent Fund financing would, as with all use of Fund resources, be subject to the requirement of balance of payments need.

8. Symmetry

Symmetry provisions would be established for contingent Fund financing. In cases in which, on the basis of observed shocks, a favorable net deviation occurred before a contingency financing purchase had been made, reserves would be increased; purchases under the basic arrangement also would be reduced by a proportion of the favorable net deviation. The proportion would normally be the same as the proportion of unfavorable deviations financed by the Fund, but priority would be given to a reserve buildup in cases in which reserves were low. The symmetry provisions would be activated if the net deviation was greater than a threshold equal in size to the threshold for unfavorable shocks, and on the basis of a review. As in the case of unfavorable shocks, the threshold would not be deductible. Where an unfavorable deviation was reversed after contingency financing purchases had been made, the part of the favorable deviation not applied to an increase in reserves could be used to reduce purchases under the basic arrangement or, at the option of the member, to repurchase earlier contingency financing purchases.

9. Eligibility of arrangements under the structural and enhanced structural adjustment facilities for contingency mechanisms

It has been agreed that it would be desirable to permit contingency mechanisms to be attached to arrangements under the structural and enhanced structural adjustment facilities. In view of the limited amount of resources available to the Special Disbursement Account and the ESAF Trust and the restrictions on their utilization, financing for this purpose would need to be provided from the Fund's general resources. The possibility of providing for concessionality in the resources disbursed under contingency mechanisms for low-income countries will be reviewed at a later date, on the basis of experience with contingency mechanisms and an assessment of the prospects of obtaining additional concessional resources.

The use of the Fund's general resources for contingency financing for arrangements under the structural and enhanced structural adjustment facilities raises issues with respect to the uniformity of treatment of Fund members. For this fundamental principle to be maintained, the conditionality attached to the use of the Fund's general resources under a contingency mechanism must be the same, whether this is in connection with an arrangement under the structural or enhanced structural adjustment facilities or an upper credit tranche arrangement.

This does not pose difficulties with respect to the enhanced structural adjustment facility, but in the case of the structural adjustment facility the degree of conditionality required is less than that for upper credit tranche arrangements. Therefore, to enable a contingency mechanism to be activated for an arrangement, under the structural adjustment facility, it would be necessary for the member concerned to agree to a program sufficiently strong to permit the Executive Board to determine that the particular arrangement under the structural adjustment facility in question entailed conditionality equivalent to that of an upper credit tranche arrangement. It would also, as a practical matter, be necessary for such arrangements under the structural adjustment facility to incorporate stronger provisions for monitoring, including a review to change benchmarks as necessary and to formulate them in a way that would govern the phased disbursements under the contingency mechanism, as well as to activate the mechanism.

The issue of uniformity of treatment also could arise with respect to the potential access of members to contingency resources. The principle of uniformity precludes a differentiated overall ceiling on access to the Fund's general resources. Therefore, a member eligible for arrangements under the structural and enhanced structural adjustment facilities

should not, by virtue of its eligibility both for arrangements under those facilities and for upper credit tranche arrangements, have higher potential access to the Fund's general resources under the contingency mechanism than a member who is not eligible for arrangements under the structural and enhanced structural adjustment facilities. Accordingly, potential access under contingency mechanisms attached to arrangements under the structural and enhanced structural adjustment facilities and, if applicable, stand-by and extended arrangements would not exceed the lower of 65 percent of quota, 70 percent of access of the underlying arrangement, or 70 percent of the member's unused access to the general resources of the Fund.

10. Eligibility of enhanced surveillance procedures for contingency mechanisms

The attachment of contingency mechanisms to the procedures for enhanced surveillance would be examined further in the context of the review of enhanced surveillance.

11. Coverage

As a general principle, contingency mechanisms would cover unanticipated changes in the exogenous components of a few key external variables: export earnings, import prices, and interest rates. Other current account transactions (such as tourist receipts and migrant workers' remittances) could also be covered where they are of particular importance. Capital movements and unanticipated shifts in the volume of imports of goods and services would not be covered. Natural disasters would not be covered by contingency mechanisms, but could give rise to assistance under the Fund's policy on emergency assistance related to natural disasters.

Coverage in the context of a particular Fund arrangement would be determined on a case-by-case basis, in discussion with the authorities. In all cases, the specific set of variables selected would need to cover a substantial proportion of the exogenous components of the country's current account. At the same time, the authorities and the staff would have sufficient flexibility in determining coverage to avoid complications in the calculations of baselines and contingencies that could substantially delay agreement on programs and activation of the contingency mechanism. The subset of variables covered would be specified at the inception of the program and would remain unchanged throughout the life of the associated arrangement.

Contingency mechanisms would cover unforeseen changes in nominal interest rates, and would be limited to changes in benchmark international interest rates, such as the London inter-bank offered rate (LIBOR). Accordingly, unexpected

deviations in interest costs stemming from changes in the risk premium, exchange rates, and unanticipated external borrowing would not be covered. Fund financing of interest rate contingencies would apply to deviations in net interest payments (payments on gross external debt minus receipts on officially owned foreign assets) and would apply only to instruments that are affected by unforeseen changes in interest rates.

Contingent financing of interest costs would be subject to a cumulative sublimit of 35 percent of quota. (Calculations illustrating the possible effect of interest rate coverage on the use of Fund resources are presented in Appendix B.) When such a limitation applied, the calculation of the aggregate contingent deviation would be modified so as to avoid triggering the symmetric provisions of the mechanism in situations where the country would otherwise have experienced a contingent shortfall. (Numerical examples illustrating how the proposed modifications would work in specific situations are provided in Appendix C.) Parallel contingent financing from commercial banks will be pursued vigorously. However, provided that adequate financing of the program is assured, there would not be a formal requirement for advance coverage of interest rates and other contingencies by mechanisms established with commercial banks. Countries also would be encouraged to hedge a part of their foreign debt against unforeseen rises in world interest rates, on the basis of the several instruments available in world financial markets.

12. Calculation of contingent deviations

Contingent deviations for individual current account variables would be calculated in relation to a baseline projection specified at the inception of the program. The aggregate size of the contingent deviation for a particular member would then be calculated as the net sum of deviations from baseline values for individual variables.

In preparing the baseline projections the staff would draw on world economic outlook forecasts of key variables, supplemented as appropriate by country-specific variables, and taking into consideration the country's circumstances. The key world economic outlook projections would be updated as necessary to provide an adequate basis for the calculations. The baseline normally would be specified for a period of 12 months, and in any case no longer than 18 months. Extended arrangements and those under the enhanced structural adjustment facility would call for specification of annual baselines at the beginning of each program year.

In calculating the contingent deviations, the staff will be guided by the principle of exogeneity. Application of this

principle would be straightforward for most import prices and export prices of key internationally traded commodities. For countries with a diversified export base--typically including a substantial proportion of manufactures--the staff will estimate the impact of unforeseen changes in external demand on export earnings. As regards interest rates, the contingent deviation would be calculated by multiplying the stock of net external debt specified in the baseline by the unexpected deviation in the nominal LIBOR, or the appropriate benchmark rate where liabilities are denominated in currencies other than the U.S. dollar. When necessary, the calculation of contingencies would take into account information--particularly with respect to longer-term contracts--about the lags with which changes in world prices and international interest rates have an effect on the member's current account.

13. Compensatory financing element

In situations where the member's record of cooperation in recent periods had been unsatisfactory, or where its policies were seriously deficient, the compensatory financing element is to be made available in two tranches of equal size, each 20 percent of quota, given reasonable assurance that policies corrective of the member's balance of payments problems would be adopted.

14. Approval in principle

When compensatory financing requests are accompanied by Fund arrangements approved in principle, purchase of the full compensatory financing element--40 percent of quota--would be allowed for members with a good record of cooperation, and purchase of the first tranche--20 percent of quota--of the compensatory financing element would be allowed for members with a less satisfactory record of cooperation.

15. Cereal decision

Overall access under the cereal decision and the compensatory and contingency financing facility will be 122 percent of quota, as set out under alternative A in the annex to EBS/88/100. Symmetry with the agreement to maintain access at its current level of 83 percent of quota for export shortfalls--as indicated in the Chairman's informal remarks of April 7, 1988 (see Informal Session 88/5, 4/7/88)--would suggest leaving in place the existing joint limit of 105 percent of quota for members with a satisfactory balance of payments position except for the effects of the cereal excess/export shortfall. This approach implies a potential to include access for contingency financing up to an overall access limit of 122 percent of quota.

16. Transitional arrangements

Under transitional arrangements, (i) there would be access of 40 percent of quota for compensatory financing for countries with outstanding contingency financing purchases of more than 65 percent of quota; and (ii) compensatory financing requests on which discussions were initiated before the approval of the new decision would be governed by the current compensatory financing decision for a period of three months after the approval of the new decision.

17. Calculation of compensable export shortfalls

a. Projection limits

There would be an upper limit on the projections of export earnings to be used in the calculations of export shortfalls. The limit on the projected growth of the average level of exports in the two postshortfall years over the average level of exports in the two preshortfall years would be set at 20 percent. Periodically, this limit would be reviewed, an if necessary revised, in the context of developments with respect to world inflation.

b. Adjustment for overcompensation

A compensatory financing request based on a shortfall falling within or overlapping with the two-year projection period of an earlier purchase would be adjusted by the amount by which the earlier purchase may have been overcompensated. Similarly, any undercompensation of the first purchase would be added to the subsequent shortfall when determining the size of the second purchase.

18. Avoidance of double compensation in compensatory and contingency financing

In calculating compensable amounts under the new facility, the staff will apply procedures to avoid double compensation between compensatory and contingency financing along the lines outlined in EBS/88/100. Under the procedures, a member with a contingency mechanism that includes export earnings as a variable should be able to be compensated under both contingency and compensatory financing, provided the amounts compensated under one component are deducted from the amounts to be compensated under the other. The member will have the choice to classify the amount of compensation deemed common to both contingency and compensatory financing as a purchase under either component.

19. Review

In many of its aspects, the new facility will be implemented on an experimental basis. As each case comes before the Board, and is commented on by Directors, that experience will be duly incorporated in and reflected by subsequent cases. Then, after about one year, there will be a general review of the compensatory and contingency financing facility based on the cumulative experience with the facility.

On the basis of the Executive Board discussion of the above issues, the draft decisions in EBS/88/128 would be revised as necessary for possible final decision by the Executive Board in mid-July.

The Chairman explained that the draft decision on the compensatory and contingency financing facility as set out in EBS/88/128 was on the agenda only as background material; as agreed, discussion and adoption of the draft decision would take place at a later stage. The staff's statement attempted to systematically set out the understandings reached by the Board at its most recent meeting on the subject (EBM/88/101, 6/27/88) and at the subsequent working lunch. It had to be ensured that those understandings were correct and generally, though informally, agreed. He suggested that any Directors with general comments make them at that time.

Mr. Grosche said that he found the staff statement generally satisfactory and appreciated the many efforts made by the Chairman, the staff, and a number of Directors to alleviate his chair's concerns about contingency financing and, in particular, interest rate contingencies. His authorities' reservations against the financing of unforeseen interest increases went far beyond liquidity considerations for the Fund, and included the likelihood that such financing would influence lending and borrowing behavior, thus adding to the instability of interest obligations that countries had to carry. Interest rate contingencies could weaken efforts to secure low and stable interest rates and to contain interest rate spreads. Moreover, such financing would likely shift part of the financing burden away from commercial banks to the Fund, thus amounting to a partial bailout of commercial banks. In that light, both the proposal to introduce a limit on the financing of interest rates of 35 percent of quota and the assurance that parallel contingency financing from commercial banks would be pursued vigorously were welcome, but minimum, safeguards that should be incorporated into the decision.

It should be stated in the Chairman's summing up that when additional financing was required owing to steep increases in interest obligations, the Fund would have to seek additional financing from commercial banks before it could disburse its own resources for that purpose, Mr. Grosche went on. It went without saying that the Fund had to insist on full financing of any program that it supported, but that fundamental principle should be mentioned again. Ideally, the summing up should also contain a

statement urging countries to make genuine efforts to hedge as much as possible of their foreign debt obligations against unforeseen rises in world interest rates.

The new facility with all its complicated technicalities, would increase the staff's work load and strain the Fund's liquidity more than originally anticipated, Mr. Grosche noted. It would be appropriate, therefore, to implement the new facility on an experimental basis and to review it after about one year.

Mr. Nimatallah said that he could associate himself with Mr. Grosche's remarks.

Mr. Salehkhou asked that the summing up explain how the Board had remained faithful to preserving the essential features of the compensatory financing facility in the new combined facility. That had been agreed by the Board and had also been part of the Interim Committee's guidelines.

The Chairman suggested that Directors consider Sections 1-4 of the staff statement.

Mr. Templeman said that, on access limits, his impression had been that there had been an agreement to be flexible about front-loading, but that such a practice would not necessarily be practiced "normally," which was the wording in the staff statement.

The Director of the Exchange and Trade Relations Department remarked that the word "normally" reflected the position of the Board on front-loading.

The Secretary agreed that there had been considerable support in the Board for front-loading, so that the expression "normally" did capture the wish of the Board.

Mr. Templeman indicated that he would consult on that question with Mr. Dallara, who had had a different understanding of the Board's position.

Mr. Posthumus remarked that he could support Mr. Grosche's general introduction.

In Section 2 of the staff statement, which dealt with activation, it was stated that in exceptional cases where the link between additional financing needs and the relevant contingencies and the policy actions that would need to be phased in could be specified in advance with sufficient precision, disbursement of contingent financing might proceed without Executive Board review, Mr. Posthumus noted. As he recalled, it had been part of the compromise prior to the Interim Committee meeting that such cases would be possible. However, since financing would now be on an ex ante basis, he felt that the Board should be notified if such an exceptional case occurred.

Mr. Grosche said that he agreed with Mr. Posthumus's suggestion, and added that that notice should be sufficient for Executive Directors to reflect on the case in question.

Mr. Donoso said that he expected that a case would be judged "exceptional" after discussions took place in the context of the other aspects of the negotiation. It did not seem necessary to notify the Board of a specific detail that would be part of a more complete discussion.

Mr. Posthumus noted that the case in question was the only one in which the external contingency mechanism could be activated without a specific Board decision. The situation had been discussed prior to the Interim Committee meeting and it had been agreed that in specific cases--when one could specify in advance the contingency and the accompanying policy action--to allow automatic drawings. He was simply asking for the Board to be notified.

Mr. Donoso asked whether Mr. Posthumus and Mr. Grosche wanted the Board to be notified before the program was brought to the Board.

The Chairman explained that the Board would be notified of the existence of an external contingency mechanism, as well as its characteristics, at the time of program approval.

Mr. Templeman remarked that the Chairman had stated in his informal remarks of April 7 that in such exceptional circumstances there would be no Executive Board review but that the Board would be informed. He supported Mr. Grosche's point that notice had to be given sufficiently in advance. That notice would take place well before the time of contingency mechanism activation.

Mr. Cassell said that he had been surprised that the first limit referred to in the section on access limits for contingency mechanisms was the 70 percent of access under the associated arrangement. As he saw it, the cumulative access limits of the two elements plus the optional tranche (40 + 40 + 25) were the primary access limits, with the 70 percent of access under the associated arrangement being a supplementary limit.

He shared the views of Mr. Posthumus and Mr. Grosche on activation, Mr. Cassell said, and asked that a specific reference be made to the need for Executive Board decisions--whether after discussion or on a lapse of time basis--be required in all cases.

The Secretary indicated that, in general, activation would be on the basis of a Board review. In some cases, the review could be put to the Board on a lapse of time basis, and for the exceptional cases described in Section 2 of the staff statement no further decision, but simply notification, would be required by the Board. Any activation would take place in the framework of a program previously approved by the Board, which would have set out when and how activation could take place.

Mr. Cassell commented that, accordingly, the wording "at some stage there is a Board decision" could legitimately be included

The Secretary agreed that a Board decision would take place when the program, containing a contingency, was approved.

Mr. Templeman remarked that he was surprised to see a reference to decisions on a lapse of time basis. He had understood that decisions would take place either on the basis of a Board meeting or not at all. No reference to decisions on a lapse of time basis had been made in the April consensus.

The Chairman remarked that while the possibility of lapse of time consideration had not been ruled out absolutely, it had been agreed that for the first year of the new facility's operation it would be reasonable to have most cases brought before the Board in order to familiarize Directors with all the complexities of the facility.

Mr. Nimatallah said that he had no difficulty with approval by the Board in a meeting or on a lapse of time basis, but it seemed to him that contingency financing could not be disbursed simply on the basis of notification to the Board. Otherwise, the amounts to be distributed would have to be specified at the time of the program design.

Mr. Rye agreed with Mr. Nimatallah that while the Board would have made a decision setting out the specificities of the external contingency mechanism, it could not outline the precise amount of the disbursement until the extent of the contingency was known. A Fund disbursement could not be made without the Board having made a specific decision as to the amount of that disbursement. He would be willing to accept lapse of time approval, even on a very short basis, but did feel that disbursement required a specific Board decision.

Mr. Zecchini recalled that the suggestion to allow disbursement on the basis of Board notification had been based on the Mexican case.

The Director of the Exchange and Trade Relations Department recalled that the contingency mechanism in the Mexican case had been tied to a change in the price of oil. As approved by the Board, if that price fell below a certain specified level, purchases might be made available. If the price exceeded a certain level, symmetry provisions would be invoked. In that sense, the Board had been asked to take a decision regarding possible future purchases with a clearly specified method of calculation.

The General Counsel noted that in the case of purchases under stand-by arrangements, the Executive Board had granted advance authorization of purchases to be made by a member. Then, the staff was only required to make a technical determination of whether the performance criteria had been met and of the timing of purchases. In such a case, no subsequent decision by the Executive Board was required, since the staff was merely implementing the advance approval given by the Executive Board.

The second case was when the Executive Board had provided only a general framework, for example, when approval had been given only in principle, the General Counsel added. Then, the staff would have to return to the Board with a member's request for a particular purchase and the Board would determine, inter alia, whether or not the conditions had been met, the amount of the purchase, and the details of phasing.

Mr. Templeman noted that the Chairman, in his informal remarks of April 7, had stated that in exceptional cases such as those currently being discussed the staff assessment could be expedited and, after the Board had been informed, disbursements would be made. When his chair had accepted that language, it had viewed such a situation as very unusual and unlikely, but not to be precluded.

Mr. Kafka said that he supported Mr. Templeman's position on automatic activation.

Mr. Fogelholm asked what the outcome of the discussion on activation had been.

The Secretary said that, as he saw it, the language of Section 2 would not be changed, with the clear understanding that in exceptional cases the Board would receive adequate advance notification. If the specifics of the program were sufficiently defined at the outset, such notification would be sufficient for a country to draw on the contingency mechanism.

Mr. Kafka recalled that the second sentence of Section 4--choice of the optional tranche--read: "Prior to activation, members would be free to choose the application of the optional tranche, except when the Fund at the request of the member specifies an allocation of the optional tranche..." It seemed preferable to state that the member itself specified the allocation of the optional tranche. In addition, he did not see why members had to commit themselves on the use of the optional tranche at the time of activation of the contingency mechanism. It would appear sufficient for a member to commit itself only on that part of the optional tranche that was activated.

The Director of the Exchange and Trade Relations Department agreed that the wording of the second sentence could be changed to reflect the fact that a member itself decided on the allocation of the optional tranche. With respect to commitment on the use of that tranche, the wording used by the staff had been agreed to at the Executive Directors' lunch. Not only did such a commitment facilitate administration of the facility, but there was also a certain logic to knowing, for the remainder of the external contingency mechanism's life, the adjustment/financing mix.

The Chairman asked that Directors consider Section 5--on the minimum threshold--and Section 6--on the proportion of the deviation to be financed--together.

The Director of the Exchange and Trade Relations Department indicated that Section 5, together with Appendix A, sought to meet the concerns expressed by some Directors. The staff had been careful in its drafting not to leave the impression that programs would no longer require margins once the new facility was in place; a well designed program should always have built-in margins. The provision in the penultimate sentence of Section 5--that contingency financing would not be provided to finance the part of the deviation within the threshold if that threshold was covered by the margin in the basic program--probably would not be frequently invoked.

Mrs. Filardo noted the importance of the size and the deductibility of the minimum threshold. It had been acknowledged in the last Board discussion on the subject that if the threshold was small, deductibility would not be an issue. Therefore, although the staff had proposed a threshold range, a minimum threshold of 10 percent of quota had finally been agreed to, with management having the freedom to propose a lower or higher figure where appropriate. It had also been agreed that the threshold would not be deductible. Nevertheless, the selection of a particular figure had been arbitrary and the figure could be too low or too high depending on the country in question. If the threshold was too high, deductibility became a relevant issue.

Her understanding was that once a deviation occurred and triggered the external contingency mechanism, that deviation would be included in the calculation of the amounts to be financed by the contingency mechanism, Mrs. Filardo went on. However, as she saw it, the staff was introducing a new element by stating that: "The staff would evaluate the margin being incorporated in the Fund arrangements and to the extent that the threshold was covered by such margin in the basic program, Fund contingency financing would not be provided to finance the part of the deviation within the threshold." In Appendix A, the staff then assessed the difficulties in quantifying margins. However, the question of margins should not be introduced in the current discussion. For a member entering into a program with an external contingency mechanism, the amount of the threshold should be made clear from the time of program approval. It should also be made clear that the threshold would constitute part of the total deviation to be financed by the external contingency mechanism and *under no circumstances should it be assumed that the threshold would be* covered by a program margin. That would destroy the spirit of the external contingency mechanism.

The Chairman remarked that the sentence referred to by Mrs. Filardo was a fair reflection of the agreement reached by Directors over their working lunch. Mr. Goos had been concerned about the question of contingency versus built-in security margins. Even after an external contingency mechanism was activated, it was useful to have some margin in the program to avoid too tight a situation for the member country.

The Director of the Exchange and Trade Relations Department recalled that the issue had been triggered by Directors who were concerned that

double compensation could be built into the system if both margins and external contingency mechanisms existed. It was the staff's intention that the provision under discussion would only be activated in cases in which a serious anomaly existed, and it would be specified ex ante.

The Chairman noted that some flexibility and judgment had to be left to staff and management to deal with such issues in a fair manner.

Mrs. Filardo said that while it was reasonable to take a program's margin into account, there should not be a link between margins and the deductibility of the threshold.

Mr. Kafka indicated that he supported Mrs. Filardo's views.

Mr. Dallara suggested that the freedom of management to propose a higher or lower threshold in relatively few cases could be limited by using the term "in those cases where this was necessary" instead of "where this was appropriate." That would make it clear that the 10 percent threshold would only be changed in exceptional circumstances.

He also shared Mrs. Filardo's concerns on the link between margins and the threshold, Mr. Dallara went on. The basic agreement had been to create a straightforward de minimis threshold without deductibility, but the discussion of margins in Section 5 went quite far toward reversing that agreement. If the Fund tried to build margins into most programs and then deducted the margin from the threshold, it would revert to a situation in which frequent deductibility was possible. He realized that the staff had tried to capture a complex compromise, but the results might be stronger than originally intended. A country reading the language as it stood might be discouraged from building a margin into its program because that might delay its access to contingency financing, while the desired effect was to encourage the inclusion of margins in programs. He therefore suggested that the language of the penultimate sentence be changed slightly to read: "...Fund contingency financing might not be provided to finance part of the deviation." There would then remain the possibility for management to decide whether it was appropriate to provide contingency financing when program margins existed.

Mr. Grosche said that his chair believed in the usefulness of having all Fund-supported programs secured by building certain security margins into programs. Assuming that financing of programs covered those margins, the margins should be deducted from any contingency financing. The staff had attempted in Appendix A to explain the many problems involved in building margins into programs, which should not be duplicated by the contingency mechanism. If such double compensation was avoided, he would be satisfied. He acknowledged that the necessary calculations were complicated, but if one was not willing to deduct automatically a fixed percentage amount from contingency compensation, such calculation was the only solution.

The Deputy Managing Director remarked that the issue of margins became more complicated when one looked at different cases. There could be cases in which the country itself wanted to build a prefinanced contingency into the assumptions of a program so that it would not have to obtain contingency financing from either the Fund or the commercial sector. In the Mexican case, a range within which the country would prefinance the contingency had been built into the program; the fact that that range existed had been useful in explaining to the commercial banks why the reserve buildup was as large as it was and why it was necessary for that reserve buildup to be included in the basic package. It had been made clear to all concerned that within that range the contingency would not be activated, and vice versa. Mexico had therefore benefited from stronger up-front financing together with a contingency that dealt with price movements outside a certain range. Some countries might want to have that flexibility built into their approach to the contingency financing mechanism.

Mr. Donoso said that, as he understood Mr. Grosche's approach, margins would be built into the programs but would disappear after the first external shock. It seemed that these margins should be maintained after the shock as well.

The Chairman remarked that Mr. Donoso's point was valid; a country could experience an external shock at the very beginning of a program, in which case it would not be reasonable to use up all the margins before using the contingency financing. Such a practice would give a country incentive either to have no margins, in which case it would only use contingency financing, or to have the broadest possible margins and not use the contingency financing at all. Either case would complicate the ordinary working of the Fund's instruments.

Mr. Grosche said that he had little to add to the discussion on whether margins should be built into programs. As he saw it, additional contingency financing should be allowed after the initial shock so that, for example, if import prices rose by 5 percent, 1 percent of that increase should be taken up by the country's policies. His authorities would prefer the simpler approach of automatic deductibility, but since some Directors did not favor that, he was willing to go along with a more complicated system.

Mr. Fogelholm agreed that automatic deductibility would be much simpler. The question of margins was also important from the point of view of equal treatment of member countries. There would be no incentive to build margins into programs unless the Fund insisted on them, since those programs without margins would then clearly benefit from the contingency mechanism. That should not be the case; all members were to be treated equally. Therefore, it would be better to return to a system of deductibility; the current approach was feasible only if each program included a margin.

Mr. Dallara recognized that deductibility might be simpler in some respects. However, it would be equally simple to have a de minimis threshold, discarding the notion of deductibility. The Board was searching for an acceptable compromise, which was the reason for the complexities at hand. Did the logic of Mr. Grosche's argument not also apply to drawings under Fund arrangements in support of programs and to compensatory financing drawings? Why, then, should margins not be deducted in the basic design of those programs as well? If margins were to be taken that seriously, they should be applied across the board. The goal was to find language that avoided double compensation when there were clear indications of a margin and there did not seem to be a need for immediate contingency financing. For the bulk of the cases, however, the de minimis threshold would be sufficient.

Mr. Posthumus remarked that, in the current debate, his sympathy lay with the arguments of Mr. Fogelholm and Mr. Grosche. However, the way in which the discussion was developing was rather confusing. The concept of a threshold had been introduced to prevent excessive activation of the contingency mechanism. The way in which the new facility had been developing, with nondeductibility, ex ante financing, and the 100 percent financing of deviations that many Directors supported, was a disincentive to member countries to build margins into their programs. The only solution he could see to such a systemic problem was to accept deductibility regardless of the disadvantages it might hold. The agreement arrived at over the working lunch with respect to margins was not the answer; few programs had significant margins built into them, and the new facility would be a disincentive to build them up any further, resulting in a vicious cycle.

The Chairman remarked that the Fund tried to establish margins in an evenhanded fashion, although that might not appear to be the case ex post.

The Director of the Exchange and Trade Relations Department noted that the current discussion assumed that only unfavorable contingencies would occur. However, favorable contingencies would also take place. In such a case, if a margin had been built in by deliberately underestimating the price of a major export product and prices indeed turned out to be higher, symmetry provisions would be activated. Again, that would be a disincentive to creating margins.

Mr. Rye observed that the concept of contingency financing was based on a balance between adjustment and financing. Therefore, there was a trade-off between Sections 5 and 6, in that if nondeductibility were agreed to, a lower proportion of the deviation should be financed.

The Director of the Exchange and Trade Relations Department suggested that the language of Section 5 be changed slightly. It had been agreed that the word "appropriate" would be replaced by "necessary." Then, the penultimate sentence could read: "...Fund contingency financing might not

be provided to finance part of the deviation," thus omitting the words "within the threshold." The reference to Appendix A would be retained.

Mr. Grosche remarked that he was not satisfied with the proposed language.

Mr. de Groote suggested that the first sentence of Section 5 be further qualified by adding "in order to avoid double compensation," which would define how the threshold would be limited.

On the question of program margins, Mr. de Groote remarked that if the principle of including margins in all programs were accepted, the Board would have to re-examine its policy on waivers, which were currently granted when a certain performance clause had not been implemented. Would it now be the case that the performance clause would include some leeway before a waiver was needed? He had always considered waivers to be a very useful feature of Fund-supported programs. Accordingly, he suggested that it be made clear in the summing up that Fund-supported programs would indeed have performance clauses that allowed for margins.

Mr. Grosche said that while he was willing to discuss the concept of margins at length, he was not sympathetic to the introduction of margins in performance criteria.

The Chairman suggested that when the debate on that subject was reopened, Mr. de Groote could provide the Board with a short statement on the matter.

Mr. Zecchini remarked that a distinction should be made between margins and the use of instruments and margins and the adjustment strategy. He saw more legitimacy in looking at margins in terms of targets or, in other words, the amount of adjustment that a country had to make.

Mr. Ismael said that, on the proportion of the deviation to be financed, his understanding had been that Directors had agreed to normal financing of 70-85 percent of the deviation, while not excluding the possibility of 100 percent financing in exceptional cases. He would prefer to mention those specific figures in the decision rather than using a vague formulation about the proportion of financing being determined on a case-by-case basis.

Mr. Kafka indicated that he strongly supported Mr. Ismael's intervention.

Mrs. Filardo indicated that she, too, supported Mr. Ismael's suggestion.

Mr. Vasudevan remarked that his chair understood that the position set out by Mr. Ismael had been agreed to at the working lunch.

The Secretary confirmed that Mr. Ismael's suggestion had been accepted at the working lunch.

The Chairman asked the staff to incorporate more precisely Mr. Ismael's suggestion into the text.

Mr. Posthumus commented that while he recalled Mr. Ismael's proposal, he did not remember it being suggested for inclusion in the decision. While Mr. Ismael's suggestion might reflect the Board consensus, it made no mention of the adjustment effort that was also needed if a contingency occurred. That issue had been unclear since the original proposal on contingency financing made by Secretary Baker at the 1987 Annual Meetings, and it now seemed that the emphasis was on financing the deviation as much as possible, by definition excluding attention to the equally necessary adjustment. He was therefore hesitant to set definite figures as guidelines on contingency financing.

The Chairman recalled that Mr. Grosche's first point at the current meeting had been that the need for a mix of adjustment and financing when a contingency arose was a constitutional element of the new facility. That concept would be reflected in the decision, summing up, and other documents associated with the compensatory and contingency financing facility.

Mr. Posthumus said that he could still not go along with a specific figure being expressed in the decision, since that prejudged the adjustment/financing mix. However, he could accept the inclusion of Mr. Ismael's proposal in the summing up.

Mr. Cassell said that it should be made clear in the decision and the summing up that when a reference was made to the proportion of the deviation to be financed, that amount was to be financed not only by the Fund but also by other sources.

The Chairman acknowledged Mr. Cassell's point and observed that parallel financing by commercial banks and other contributors was called for in all cases, and not only when the deviation was caused by interest rate movements.

The Director of the Exchange and Trade Relations Department remarked that Mr. Cassell's concern had been covered in a subsequent section.

Mr. Dallara said that attempting to prespecify the proportion of the deviation to be financed, in addition to complicating discussion of the role of supplementary contingency financing, would not be of much utility since what the contingency would consist of, its effect on the economy, and its size, would not be known in advance. The Fund might simply not be able to meet a prespecified proportion if a particularly large contingency

occurred. The country concerned would then have to undertake an unexpected dose of adjustment. His preference would be to leave Section 6 as it was currently drafted.

Mr. Marcel said that he supported Mr. Dallara in his opposition to Mr. Ismael's proposal.

The Chairman noted that the section in the decision would remain as it was, but the question under discussion was whether to refer in the summing up to the fact that a number of Directors agreed with Mr. Ismael's suggestion. That statement would be accompanied by strengthened references to the need for adjustment and for bank financing in all cases, and not only when the deviation was due to interest rate increases.

Mr. Fogelholm supported the retainment of the text as it stood. He would welcome increased specification regarding parallel financing in order to ensure the financial viability of programs.

Mr. Donoso noted that a country could accommodate a contingency by changing the level of its reserves as well as by use of Fund resources or by adjusting. It should be made explicit that any contingency should be dealt with in part by each of those three options. However, the symmetric reaction to adjustment would be expenditure, and not accumulation of reserves as was currently being suggested.

The Chairman remarked that a country's order of preference with respect to symmetrical reactions depended on the specific country case. The Fund could not preselect the order in which symmetrical actions would take place.

Mr. Donoso noted that his proposition was simply to keep in mind that there were three options.

The Chairman, in response to a question by an Executive Director, indicated that the summing up of the current meeting would be distributed in sufficient time for Directors to react to any changes in the text.

The Director of the Exchange and Trade Relations Department introduced Section 7, on phasing, by pointing out that the only change was the addition, at the suggestion of one Executive Director in particular, of the sentence in parentheses. The sentence broadly followed the language of the compensatory financing facility.

On Section 8, the staff had interpreted symmetry to mean symmetry between Fund financing and abstention from Fund purchases, the Director continued. For example, if the Fund had agreed to finance 40 percent of a deviation due to unfavorable circumstances but favorable developments occurred instead, the current draft suggested that the member would forgo purchases equivalent to 40 percent of the favorable deviation. However, priority would be given to a reserve buildup in cases in which reserves were low. If the favorable development occurred after a contingency

mechanism had been used, then instead of forgoing purchases from the Fund the member could, at its option, repurchase the contingency financing that it had used.

Mr. Zecchini asked, first, whether the second sentence of Section 8--in which it was stated that when a favorable net deviation occurred before a contingency financing purchase had been made, reserves would be increased--implied that the increase in reserves would be made by drawing on the contingency element. Second, would the reduction of purchases under the basic arrangement by a proportion of the favorable net deviation take place at a later stage rather than at the initial drawing? Paragraph 8 described a situation in which a favorable net deviation occurred before a contingency financing purchase had been made.

The Director of the Exchange and Trade Relations Department indicated that up to the last sentence of Section 8, the assumption was that no drawing had taken place under the external contingency mechanism. If a favorable contingency arose after an external contingency mechanism had been approved by the Board, symmetrical action would need to be taken as long as the favorable contingency exceeded the threshold. There were two possible types of action: first, adding to reserves, and second, reducing the purchases under the basic arrangement. The proportion in which those two actions should take place was dealt with in the second sentence of Section 8, which stated that the purchases under the basic agreement would be reduced by the same proportion of the deviation as that which the Fund would have financed had the deviation been unfavorable. If reserves were low, however, an exception would be made to place priority on reserve buildup.

He recognized that there were more simple solutions, the Director of the Exchange and Trade Relations Department remarked. For example, it could be stated that, for a favorable deviation, there should be a buildup in reserves until those had reached a satisfactory level, after which consideration would be given either to a reduction in purchases or, if a contingency drawing had already been made, to a repurchase of that or other purchases. However, it was not clear that the majority of Executive Directors favored such a solution.

Mr. Posthumus noted that making an exception for countries with low reserves violated the principle of symmetry. Low reserves should have been dealt with by the country when the underlying arrangement was being set up. In addition, since there was no decrease of reserves in the case of contingency financing if the threshold was not deducted, there should be no subsequent buildup of reserves.

The Chairman remarked that it was possible for a country with a program to have low reserves, particularly when the Fund's financing was limited because, for example, the country's exposure to the Fund was too high. In such cases, it made sense for both the country and the Fund to take advantage of a positive contingency through an increase in reserves.

Mr. Posthumus noted that in the example mentioned by the Chairman the country had already drawn substantially from the Fund and should therefore make a repurchase of those drawings.

The Chairman remarked that he saw merits in taking advantage of a positive contingency by allowing a country to attain a normal level of reserves.

Mr. Donoso said that assigning absolute priority to the accumulation of reserves when there was a positive shock was an indication that reserves were too low in comparison to the level of expenditure. It revealed that there had been a mistake in the starting position in the sense that there had been too little adjustment at the beginning of the arrangement. A symmetric reaction was ideal if the country had been in the correct position from the beginning. In that sense, the country should correct its original position by starting out with more reserves and less expenditures, then moving symmetrically in the face of a positive deviation. Since a country was required to adjust more if it had a negative shock, it should be able to relax its adjustment if it had experienced a positive shock.

The Chairman noted that not all Directors would agree that there was symmetry between adjustment and relaxation. The Fund membership currently was experiencing a general problem of excessively low reserves, and it was not yet clear how to address that situation. At a minimum, positive contingencies could be taken advantage of to increase reserves to a normal level.

Mr. Nimatallah said that it was not easy to relax adjustment since adjustment was an ongoing process that was more difficult to resume than to continue. In addition, reserves were an important part of the adjustment process. The principle that countries should maintain a normal level of reserves had been relaxed over the past few years. It was for that reason that he had suggested in his last statement that a favorable development before an unfavorable contingency should be accommodated entirely by increasing reserves. The buildup of reserves during the adjustment period was essential for a country in that its creditworthiness improved; for the Fund in that its position strengthened; and for the banks in that their confidence increased. Accordingly, he would like the language in Section 8 to remain as it was since it gave priority to increases in reserves.

Mr. Templeman said that his preference was to give first priority to reserve buildup, with a reduction of purchases under the basic arrangement being considered if reserves were adequate, which was not often the case. In the case of a country that had already drawn on contingency financing, he would be willing to have first priority given to a buildup of reserves in most cases, but it was also very important to re-establish access under the contingency mechanism for future use, so that could be an alternative in some cases.

Mr. Chatah said that he could see the point that when reserves needed to be augmented, priority should be given to that action. He also accepted the possibility of reducing purchases under a country's basic arrangement. However, by limiting the reaction to a positive contingency to those two options, the Fund would be missing out on the possibility of a country strengthening its structural policies by taking advantage of the unexpected improvement in its external position. Such a strengthening would be more difficult if financing was withheld, in the sense that a country needed more financing to, say, liberalize the import regime or conduct other structural reforms that could take advantage of the positive development.

Mr. Posthumus said that while he did not dispute the need for a country to have reserves, he felt that symmetry should be adhered to in all cases. If a country's reserves were too low, that was an issue that should be tackled in the underlying arrangement and not through the contingency mechanism. He therefore hesitated to allow an exception to the rule of symmetry.

The Director of the Exchange and Trade Relations Department said that while he could see Mr. Posthumus's point, the Fund had always considered a buildup of reserves as a strengthening of a member's position and therefore a strengthening of the Fund's position. If a member began with low reserves it was seldom possible at the time of putting an arrangement into place to correct that situation. Indeed, some members still had low reserves at the end of a stand-by arrangement, which put them into a precarious position that might later necessitate further stand-by arrangements with the Fund. If a favorable deviation occurred, the Fund and the member would benefit substantially from the member building up its reserves.

Mr. Templeman remarked that his assumption had been that, once the Board had decided to activate contingency financing, the first tranche would be made available at the time of Board approval in all but exceptional cases. However, the language of Section 7 suggested that a first purchase would only be made available when the cumulative deviation from the baseline was projected to exceed the threshold; he would appreciate clarification of that position.

His chair did not support a repurchase provision as had been set out in parentheses in Section 7, Mr. Templeman said. He recognized that there was a similar repurchase provision for the compensatory financing facility, but that applied only in cases in which member countries had opted to use a six-month forecast for the shortfall year in calculating the export shortfall. In fact, the basic approach to the two types of financing was quite different, since compensatory financing was backward looking and contingency financing was forward looking. By definition, the contingency financing approach involved projections of program variables over the baseline period, and the deviation that was calculated depended upon an updated projection at the time of the Board review. Of course, he would expect revised projections to be based on partial data at the time of the

Board review. If the Board agreed to a repurchase obligation, which he did not support, then logically a similar requirement should be introduced for overcompensation of the compensatory drawings whenever actual data were available for the two postshortfall years that had to be projected at the time of the drawing. However, a repurchase obligation was unnecessary in both cases.

The Chairman noted that the sentence in parentheses became less useful because it would be mentioned strongly in Section 5 that the Fund intended to avoid any kind of overcompensation.

The Director of the Exchange and Trade Relations Department remarked that the staff had presumed that purchases under the external contingency mechanism would take place on the same dates as purchases under the associated arrangement in order to avoid complications. It had also presumed that the Board would decide on activation when it was reasonably certain that the contingency was about to occur. Its third presumption had been that the amount of the activation would be the amount that the Board deemed to cover the cash flow projections of the current account for the following quarter.

Mr. Templeman said that he had assumed that the activation of the contingency would typically take place at the midterm review, when the purchase under the underlying arrangement would also be released. It appeared that he therefore had no differences with the staff. He also had no problem with attempting to tranche the amounts of contingency financing in accordance with the size of the impact, although that appeared to be a complex matter.

Mr. Cassell indicated that he was in favor of the repurchase provision set in the parentheses of Section 7, considering that it was a useful point. The Board had agreed to an ex ante approach to contingency financing and it therefore seemed only reasonable to look back when one knew the actual outcome for each period.

On Section 8, Mr. Cassell said that when an unfavorable deviation was reversed after contingency financing purchases had been made, it should be stated that the part of the favorable deviation not applied to an increase in reserves "should" be used to reduce purchases under the basic arrangement, rather than "could," which was not strong enough.

The Chairman agreed with Mr. Cassell's latter suggestion, but indicated that the sentence in parentheses was now redundant since it clearly dealt with a case of overcompensation, which had been covered earlier.

Mr. Grosche said that he agreed with Mr. Cassell's suggestions. The sentence in question in Section 7 dealt with a different problem than that covered in Section 5--a problem of data. In fact, he would suggest that the sentence be strengthened by stating that "the member would be <u>required</u> to make a prompt repurchase in an amount equivalent to the overcompensation," rather than merely "expected."

Mr. Kafka said that while he did not consider the sentence in question to be redundant, it was inadvisable because it did not allow countries to increase their reserves instead of making an early repurchase.

Mr. Grosche pointed out that the case in question was one in which purchases had been made on the basis of incorrect assumptions.

Mr. Kafka commented that it was often difficult for countries that started out with low reserves to make early repurchases, regardless of whether the initial purchase had been made on the basis of accurate or inaccurate information.

Mr. Posthumus remarked that placing a priority on increasing reserves basically amounted to using the compensatory and contingency financing as a mechanism to replenish reserves, which was not the original intention.

On Section 7, he supported Mr. Cassell and Mr. Grosche in that a purchase could have been made when there was not a contingency situation overall. The netting out of variables, which was another essential element of the whole system, could in certain situations become an illusion, in which case repurchasing should be prompt and the sentence in question should be retained. Section 5 talked about double compensation, while the sentence in question dealt with overcompensation.

Mr. Fogelholm noted that the first decision to be taken was whether compensation should be made, or, in other words, whether the program margin had been exceeded, and if so, by how much. The estimation of the compensation necessary would be based on the data available, and the sentence in the bracket was necessary to correct any overcompensation based on that data.

Mr. Dallara asked whether the compensatory financing facility included an obligation of early repurchase when an estimate of export performance in the two postshortfall years was not borne out by reality, and it turned out that there had not in fact been a shortfall.

The Economic Counsellor indicated that there was currently no expectation of an early repurchase in such a case.

The Chairman noted that the language in the bracketed sentence paralleled the language of the compensatory financing facility.

Mr. Dallara asked whether the sense of expectation in the contingency element would be similar to the approach used in the compensatory financing facility.

The General Counsel indicated that the problem of overcompensation arose if a mistake was made in the calculation of the shortfall year, in which case there would be an expectation to repurchase but not an obligation.

Mr. Dallara remarked that if it were not obligatory to make a repurchase in the case of the compensatory financing facility, the need to attach such an obligation to the compensatory element was not clear, particularly since the contingency element depended more upon a system of forecasts. He would not object to language that encouraged a member to make a repurchase, but did have some hesitation in rigorously imposing an expectation of a repurchase, particularly when that was not done for the compensatory financing facility.

Mr. Cassell said that in the case of the compensatory financing facility, a member was being compensated for an event that had already occurred and for which the data were already available. However, in the case of contingency financing, the Fund was providing financing on the basis of a comparison between two projections for the future. He therefore considered a safeguard necessary to ensure that any mistake in those projections was adjusted for.

Mr. Dallara observed that the compensatory financing facility was not entirely backward looking. A certain level of export earnings was experienced, but that level only became a shortfall based on a series of calculations that always included two years of forecasts. Accordingly, the fact that an export shortfall was experienced was not fully dependent on past events, but rather, on past, current, and future events. In that sense, the determination of a shortfall was very dependent upon forecasts.

Mr. Cassell observed that compensatory financing was based on a comparison between actual data and a forecast. In contingency financing, one compared two forecasts.

The Director of the Exchange and Trade Relations Department said that the staff had considered that a mistake in the calculation of the baseline period for contingency financing was analogous to a mistake in calculations for the compensatory financing facility. However, he could see Mr. Dallara's point that perhaps the two situations could not be compared directly. In practice, the issue was even more complicated because other matters in addition to the core variables affected the current account, some of which should be brought into the net calculation of a deviation. The argument for a repurchase provision was that it would be a prudential move enabling the Fund to request a repurchase to be made if it proved that the original purchase had been based on mistaken assumptions. It was simply a question of the attitude that the Board wished to present.

The Economic Counsellor said that, on the compensatory financing facility, if one realized during the second year of an arrangement that there had been an overcompensation on the basis of available new data, the second compensatory purchase was adjusted accordingly. By the time the actual data for the two postshortfall years became available, a member was close to discharging its repurchase obligations under the three- to five-year rule, which made the issue almost a moot point. The actual data for the two postshortfall years only became available after about three

and one half years, by which time the three- to five-year rule would already have been binding and the repurchases would already have taken place.

Mr. Dallara remarked that there clearly was a great difference between an immediate repurchase obligation of a whole drawing and phasing repurchase obligations over a period that began three years and three months after the initial drawing and continued over a period of five years. The contingency and compensatory elements of the new facility were not strictly analogous. His point, however, had been that it would be rather demanding to impose a legal expectation of an early repurchase of contingency drawings in the event of a positive deviation.

Mr. Posthumus noted that the last sentence of Section 7 stated that "actual use of contingent Fund financing would, as with all use of Fund resources, be subject to the requirement of balance of payments need." How could the staff verify that need? On the basis of projections of, for example, an interest rate increase, a contingency could arise in the middle of the year, and financing would be made available. In the same period, however, actual revenues might have gone up but that would only be known after the decision had been taken to provide contingency financing. Accordingly, the netting out of variables would not take place and it would not be possible to check whether the actual use of contingency financing had been subject to balance of payments need. It was a consequence of the ex ante system that balance of payments need was no longer verifiable.

The Director of the Exchange and Trade Relations Department said that, first, he agreed with Mr. Posthumus's point that modalities of the new facility did not allow for great precision. Second, the right to claim a contingency lapsed at the end of the baseline period to which the contingency was attached, so that the possibility of overcompensation only existed for a few months. Third, logic would suggest that the sentence in parentheses, if left there, would work the other way for symmetry's sake. Therefore, if the initial calculations granted the member inadequate financing, the member would subsequently be given the right to draw more from the Fund.

Mr. Dallara remarked that one should not interpret the term symmetry too literally. He still felt that there was no need for a clear and formal legal expectation; it should be sufficient simply to encourage the member to make a prompt repurchase in the equivalent amount.

The Director of the Exchange and Trade Relations Department explained that there had been one change in Section 9 on the eligibility of structural and enhanced structural adjustment facility arrangements for contingency mechanisms, in the form of two new sentences at the beginning of the final paragraph. Those sentences had been inserted in order to work toward uniformity of treatment. The general proposition was that members could not be given additional access to the ordinary resources of the Fund under an external contingency mechanism as a result solely of their

eligibility for the structural or enhanced structural adjustment facilities. For example, if one country was eligible for the enhanced structural adjustment facility and the other was not, but both were at the absolute limit of their access to the general resources of the Fund, the former member could enter into an additional agreement under the enhanced structural adjustment facility, to which external contingency mechanisms could be attached. Because purchases under an external contingency mechanism were not subject to the general access limits, the member eligible for the enhanced structural adjustment facility could draw an additional amount on the general resources of the Fund, whereas a non-eligible member would not have that right. It was to avoid such a case that the limitation found in the two new sentences was being introduced.

Mr. Ismael said that, as he saw it, the degree of conditionality required for arrangements under the structural adjustment facility was no less than that for upper credit tranche arrangements. He therefore wondered whether there was indeed a question of uniformity of treatment. In principle, however, he could support modified monitoring provisions in order to facilitate phased disbursements under the contingency mechanism for arrangements under the structural adjustment facility. He also questioned the limitation on potential access to "the lower of 65 percent of quota, 70 percent of access of the underlying arrangement, or 70 percent of the member's unused access to the general resources of the Fund." He hoped that the staff would clarify the implications of the last limit, especially in cases in which members had already made use of Fund resources. Also, what did the staff consider an appropriate overall limit for access to the Fund's general resources in order to calculate a member's unused access?

The Director of the Exchange and Trade Relations Department said that he agreed that the conditionality attached to arrangements under the structural adjustment facility should initially be approximately equal to upper credit tranche conditionality. However, there was no provision other than the benchmarks to ensure that the degree of conditionality would be maintained throughout the three one-year periods of the arrangement. In contrast, there was such a provision for stand-by arrangements. That was the difference that made it difficult for the staff to state that the degree of underlying conditionality was the same in both cases.

Mr. Dallara noted that certain aspects of arrangements under the structural adjustment facility would need to be modified in order to make them compatible with contingency financing. He also would have thought that modification of the approach to the enhanced structural adjustment facility might need to be considered, depending on the nature of the benchmarks that evolved in an arrangement under that facility. Therefore, the language of Section 9 should not preclude modification of certain arrangements under the enhanced structural adjustment facility in order to make them compatible with contingency financing.

With respect to the last sentence of the last paragraph of Section 9, Mr. Dallara remarked that its objective had been achieved. As he

understood it, the last limit referred to in that sentence was 70 percent of the member's unused cumulative access to Fund resources, and not its annual access. That might not be a relevant ceiling at all unless a member had particularly high levels of outstanding Fund credit relative to cumulative access ceilings. Perhaps a preferable benchmark would be 70 percent of the average access under Fund-supported programs, or something along that line.

Mr. Donoso asked the staff how the limit of 70 percent of the member's unused access to the Fund's general resources would operate. It seemed that some members could be denied access to the external contingency mechanism because of heavy use of Fund resources.

The Director of the Exchange and Trade Relations Department acknowledged that the way the sentence in question stood might not precisely capture the goal of the staff. In the example he had given earlier, one country was eligible for arrangements under the enhanced structural adjustment facility while the other was not. If one assumed that both countries had reached the cumulative access limit of 400 percent, then neither of them could, under normal policies, use the ordinary resources of the Fund any further. However, the country eligible for arrangements under the enhanced structural adjustment facility would have the right to such an arrangement, to which an external contingency mechanism could be attached unless one had the modification as set out in Section 9. Because the external contingency mechanism was not subject to the access limits for general resources, the country would be able to draw more ordinary resources under that contingency mechanism, and would have greater use of ordinary resources than the other member. For reason of uniformity of treatment, the staff was seeking to avoid such an anomaly.

The General Counsel indicated that the three limits were a reflection of the different subceilings that were contemplated for the decision being discussed. The 65 percent of quota was the ceiling on external contingency mechanism purchases--40 percent contingency element plus 25 percent optional tranche. Seventy percent of access under the underlying arrangement was a general subceiling that would also apply to contingency purchases in association with stand-by arrangements. The only new subceiling was the last one--70 percent of unused access to the general resources of the Fund. That ceiling had been introduced for the reasons outlined by the Director of the Exchange and Trade Relations Department.

As an example, the General Counsel continued, one could suppose that there were two members, each of which retained access of 100 percent of quota to the Fund's general resources. The first member was not eligible for arrangements under the structural adjustment facility, and could only qualify for a stand-by or extended arrangement, for which the access limit was 40 percent of quota. Because of the subceiling of 28 percent of the underlying arrangement, the maximum access would then become 70 percent of quota. The second member was eligible for arrangements under the structural adjustment facility and had access to general resources of 40 percent of quota and of 40 percent under the structural adjustment facility,

for a total of 80 percent of quota. If the contingency financing limit of 70 percent of access were applied, that member would be entitled to contingency financing of 56 percent of quota, resulting in discrimination against the noneligible member. For that reason, it had been proposed that 70 percent of unused access to the Fund's general resources be the absolute limit on all members, whether or not they were eligible for arrangements under the structural adjustment facility.

Mr. Dallara said that the limit in question might not work when a member had made low cumulative use of Fund resources. Apparently that limit was meant to be a substitute constraint for the limit based on 70 percent of the underlying arrangement. He did not consider that a 70 percent limit tied to the high 250 percent enhanced structural adjustment facility access would be a significant limit.

Mr. Karka said that the concept of unused access did not exist in the Fund; a less precise measure would have to be used instead.

Mr. Zecchini remarked that the sentence in question referred to the lower of three limits, thus inviting comparison between three benchmarks. The third limit of 70 percent had been used instead of a reference to unused access, but since that limit was a reflection of the other two limits, there should be no reason to mention a specific percentage.

Mr. Grosche commented that the discussion at hand was academic, since no external contingency mechanisms would be attached to arrangements under the structural adjustment facility, and the enhanced structural adjustment facility would have to be modified before that could occur.

Mr. Dallara asked why an arrangement under the structural adjustment facility could not serve as a basis for contingency financing.

Mr. Yamazaki said that he was in favor of strict uniformity in the use of general resources and therefore supported the staff proposal.

The Executive Directors agreed to continue their discussion in the afternoon.

LEO VAN HOUTVEN
Secretary

Margins in Programs

As a general principle, the Fund and its members have sought to incorporate a safety margin in arrangements, although it has recently become progressively more difficult to incorporate margins of any significance because of growing financing constraints. Program margins customarily take two forms. First, a deliberately cautious evaluation of economic prospects, and second, a somewhat more cautious policy stance than might seem required by the normal relationships to achieve the main program objectives.

The implications of nondeductibility of thresholds in the presence of margins may be illustrated by the following two examples. They abstract from any complications that may result from the need to arrive at a figure for a net deviation.

1. Assume that the unbiased forecast for the price of a particular export was 100, but that in order to provide a margin the member and the Fund agreed to incorporate a price of 80 in their program calculations. In calculating the deviation for the contingency mechanism, there would first be a question of whether, for the purpose of the contingency mechanism, the baseline would be taken as 100 or 80. Assume that the unbiased projection of 100 is taken as the baseline. If the price moved to 60 during the baseline period, without deductibility contingent financing would cover the difference between the baseline value of 100 and the outturn of 60, even though a price as low as 80 had been provided for in framing the program; this could be seen as an element of double compensation. Alternatively, the baseline could be set at 80, and no double compensation would result. However, the symmetry provisions of the mechanism would be activated if a price of 100, the unbiased projection, were realized and this approach would for all intents and purposes eliminate the program's margin.

2. Another situation arises when policies have been deliberately set more cautiously than might have appeared strictly necessary for observance of the program's targets; this might be reflected in the balance of payments by an underestimation of variables not normally covered by contingencies, say, export volumes. If the normal relationships hold, the program targets could still be achieved in the event of adverse external shocks, up to the magnitude of the policy margins. However, approached from this way the balance of payments margin is substantially more difficult to quantify.

There are also other methods of incorporating margins into programs which are difficult to quantify precisely. For instance, it may be agreed that if a reserve target is not being met, exchange rate action will automatically be taken or other contingent policy measures may be contemplated; in addition, the originally targeted reserve build up may be sufficient to allow program targets to be adjusted through waivers or modifications, thus allowing a degree of margin.

Given the variety of ways in which a margin may be provided and, in practice, the great difficulty of precisely quantifying the amount of margin that has been provided for, the staff would suggest that the case-by-case approach would be preferred. The staff would draw the attention of Executive Directors to arrangements with any significant quantifiable margin, with a view to it being set aside for the purpose of calculating contingency financing or symmetry provisions.

The Implications of Interest Rate Contingencies for the Possible Use of the Fund's Resources

This appendix presents calculations of the effects of interest rate deviations on the net interest payments of the group of 15 heavily indebted countries and of the wider group of capital importing developing countries. It also examines the possible implications for the Fund's liquidity of coverage of interest rates by contingency mechanisms when such financing is subject to a cumulative sublimit of 35 percent of quota.

The implications of forecast errors for interest rates on the net and gross interest payments of capital importing developing countries over the period 1978 to 1987 were examined in detail in pages 54-61 of EBS/88/30, Supplement 1 (2/26/88). The following calculations were derived from data developed in that exercise. On the basis of the data on the net stock of external debt outstanding at the end of 1986, it is estimated that a 1 percentage point increase in LIBOR would increase net interest payments of capital importing developing countries as a group over the following 12-month period by $2.5 billion--7.3 percent of the total quota for the group. The calculation of net interest payments is based on the effect of the rise in international interest rates on short-term and long-term floating rate debt, less its estimated effect on interest receipts related to official holdings of foreign exchange. The corresponding figure for the group of 15 heavily indebted countries is $1.5 billion--13.5 percent of total quota. These calculations assume that interest payments are made on a six-monthly basis, and hence that an increase in interest rates at the start of a 12-month period would only affect interest payments in the second half of the year. In the case of a member with an arrangement with a contingency mechanism, if the baseline for a 12-month program was established, say, two months before Board approval of the arrangement, an unanticipated increase in interest rates just after the baseline had been finalized would affect interest repayments during eight months of the program period.

As far as contingent financing is concerned, only unanticipated changes in interest rates are relevant. The exercise reported in Supplement 1 to EBS/88/30 indicates that for the period 1978 to 1987 the mean absolute forecast error for "naive" one-year ahead forecasts of six-month LIBOR was 0.8 percentage points. The absolute average forecast error for world economic outlook interest rate forecasts over the three-year period to 1987 was 0.7 percentage points. For the group of capital importing countries, this would imply an increase in net interest payments of $2.0 billion--5.8 percent of quota--over a 12-month period; for the 15 heavily indebted countries the increase would be $1.2 billion or 10.8 percent of quota. This gives an indication of the typical magnitude of unanticipated interest rate shocks that could be expected in a given year. (Where interest payments are made on a six-monthly basis, interest payments in a 12-month period are affected only by changes in interest rates in the first half of the year. The prediction error over a six-month period likely would be somewhat smaller than the annual error.) It

should be noted that the mean forecast error for the same period was -0.1 percentage point, indicating that positive and negative errors were broadly offsetting over the period as a whole. (A minus sign indicates that the realized value was higher than the predicted level for the interest rate.)

As regards the possible impact on the Fund's liquidity of the proposed coverage of unexpected fluctuations in interest rates with a limit on contingency financing of 70 percent of the underlying arrangement or a cumulative sublimit on such financing of 35 percent of quota (whichever is lower), it has been assumed that all eligible arrangements would incorporate contingency mechanisms with interest rate coverage. (Based on the data used in the liquidity projections set out in EBS/88/115 (6/10/88). Not all capital importing countries are included in this group, and thus the coverage differs from that in the exercise described above.) On that basis, it is projected in the period through end-1989 that maximum Fund exposure for contingency financing of interest rate shocks would amount to about SDR 3 billion on a commitment basis. (These projections assume--with varying probabilities--that arrangements are concluded with 80 members during the period through end-1989, and possible access is weighted by the probabilities that the arrangements will be concluded. Thirty-five percent of the quotas of these members amounts to SDR 5.2 billion.) If it is assumed, as in the case of the disbursement projections set out in pages 26-27 of EBS/88/100, that only about one third of potential commitments under the contingency mechanism are actually drawn, the amount of ordinary resources required to finance interest rate contingencies would be about SDR 1 billion.

APPENDIX C

Calculation of the Net Deviation when Interest Rate Contingencies are Subject to a Sublimit of 35 Percent of Quota

A sublimit of 35 percent of quota on Fund financing of interest rate contingencies could give rise to a situation in which the symmetry provision of the mechanism would be triggered even though the net effect of the exogenous disturbances faced by the country was clearly unfavorable. (The modified rule proposed in this Appendix also would be used to avoid situations in which the aggregate deviation would give rise to contingent Fund financing even though the country faced unexpected disturbances that were, on balance, favorable.) This Appendix proposes a modified rule for the calculation of the aggregate contingent deviation that would avoid such undesirable situations. Two numerical examples are given to illustrate how the rule would operate in specific situations.

1. Under the modified rule, unfavorable interest rate deviations involving Fund financing in excess of 35 percent of quota could be used to offset net favorable deviations in other contingent variables, but not to obtain contingent Fund financing. By way of illustration, consider the case of a country facing an adverse interest rate shock equivalent to 50 percent of quota, and a favorable disturbance equivalent to 45 percent of quota with respect to all other contingent variables. (For simplicity, it is assumed that 100 percent of the deviation is covered by Fund financing; this assumption does not affect the validity of the conclusions.) Since financing for the interest contingency would be subject to the limit of 35 percent of quota, the net sum of deviations would imply a favorable contingency of 10 percent of quota. Under the modified formula being proposed, however, the aggregate net deviation would be zero, so that the symmetry provision would not be triggered.

2. As a second example, consider the case in which the unfavorable interest rate deviation was 45 percent of quota, and the net favorable deviation for other items was 55 percent of quota. In that case, there would be a favorable aggregate deviation of 10 percent of quota under the modified formula, compared with a favorable aggregate deviation of 20 percent of quota under the unadjusted procedure. In this case, the symmetry provision would be triggered, but the magnitude of the symmetric adjustment would be reduced under the modified formula.

It is proposed that unfavorable interest rate deviations that have been taken into consideration for the purpose of offsetting net favorable deviations in other items (but <u>not</u> for the purpose of obtaining contingent Fund financing) would not be applied toward the cumulative limit of 35 percent of quota on interest rate contingencies.